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Italy: Policymaking Problems and the Budget Deficit

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An Intelligence Assessment

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EUR 84-10215
October 1984

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Italy: Policymaking Problems and the Budget Deficit [redacted]

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An Intelligence Assessment

This paper was prepared by [redacted] 25X1
Office of European Analysis. Comments and queries are welcome and may be directed to the Chief, Western Europe Division, EURA, [redacted] 25X1
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Italy: Policymaking Problems and the Budget Deficit [redacted]

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Key Judgments

Information available as of 31 July 1984 was used in this report.

By complicating economic decision making, Italy's Byzantine political system has contributed to an enormous budget deficit—almost 17 percent of GDP. Authority on economic policy is divided among several bickering ministries, the prime minister's office is weak, and parliamentary procedures are tangled. Most important, government leaders must perform delicate balancing acts in formulating economic policy to satisfy the diverse parties in the typical multiparty coalitions, and major measures must receive the acquiescence of the opposition Communist Party, which controls a large segment of Italian labor.

The fruits of this system have been a rapid increase in government spending and uncollected revenues. In particular, outlays for transfers (especially pensions and unemployment compensation), salaries, subsidies to state firms, and debt service have soared since the late 1970s. Revenues have lagged, largely because the Christian Democrats have refused to strongarm the self-employed and small firms, who constitute an important part of their electorate.

Italy's leaders remain unwilling or unable to initiate the economic and political reforms needed to get the budget under greater control. Many of them do not believe that the problem is serious, and others refuse to give up the spoils of their patronage system. The few small steps taken by the Craxi government in the political reform area—such as limiting the time for debate on the budget bill and instituting a special 45-day parliamentary session for dealing with budget matters—will not, in our view, go very far to solve the problem. Proposed economic reforms to cut tax evasion and reduce pensions face formidable parliamentary hurdles.

The most likely outcome, in our judgment, is for Rome to continue its muddle-through approach and achieve, at best, only modest control over its budgetary problems. In this case, the consequences will include sustained high inflation and real interest rates, sluggish investment spending and economic growth, sharp constraints on the use of fiscal policy to manage the economy, and greater susceptibility to external shocks. The next most likely outcome is that Italy's economic problems will worsen and perhaps lead to serious balance-of-payments problems, particularly if Italy loses its standing in international credit markets.

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In the latter case, growing public pressure for more effective government could force Rome to make a more permanent structural change and find alternative governing formulas to deal with its economic problems. These could include a one- or two-party government with outside support from the minority parties. A less likely but possible alternative would be a further opening to the left, bringing the Communist Party, either directly or indirectly, into the government. An enhanced role for the Communists would probably reverse recent Italian efforts to pursue more active foreign and defense policies and could, over the longer term, raise questions about US access to Italian ground facilities and airspace in the event of a future crisis in the Mediterranean.

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Italy: Policymaking Problems and the Budget Deficit

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Introduction

The Italian economy, like those of other West European nations, suffered from the international economic downturn. After experiencing an average annual growth rate of about 3 percent in the 1970s, the economy has stagnated over the last few years, and unemployment has climbed sharply, reaching nearly 10 percent in 1983. Although a moderate recovery is finally taking hold, Italy is still faced with myriad economic problems including double-digit inflation, rising unemployment, and an expanding budget deficit. These problems are largely a product of Italy's labyrinthine political system that makes it extremely difficult to formulate and implement effective economic policies. This paper will examine the budget problem and the political factors that have contributed to it, as well as the implications of these factors for Italy's ability to deal with its problems in the future.

Soaring Budget Deficits

The expanded public-sector deficit (EPSD)[1] last year reached $58.4 billion or 16.6 percent of GDP—up from 12.3 percent in 1979. As elsewhere, the recession has contributed to the deficit's expansion by slowing revenue growth and raising outlays. A sharp rise in temporary layoffs and shortened workweeks has particularly hurt the state pension system, which compensates those affected. An even more important cause of the deficit increase, however, has been legislated raises in outlays such as pensions, which grew at a 25-percent annual rate from 1971 to 1981, about 9 percent annually in real terms. These outlays have helped push general government spending to 54 percent of GDP in 1982—the highest level among the Big Four West European nations and nearly 17 points higher than in the United States (see tables 1 and 2).

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We believe the huge public-sector deficit has crowded out some private investment and contributed to an inflation rate that has averaged 15 percent annually since 1978. Partly because of Rome's borrowing requirements, domestic credit has expanded substantially in excess of the targets set by the central bank, and monetary growth (M1) averaged 18 percent annually during 1977-82. In an effort to reduce the printing of money to fund the deficit, Rome increasingly has resorted to selling bonds to the private sector. To market these bonds, the government has sharply raised their real rates of return, which has pushed up interest rates. Italian companies, which traditionally have high debt/equity ratios, have found it difficult to make investments in the face of interest rates of 20 to 25 percent. Adjusted for inflation, the real interest rate stood at 4.5 percent in the last quarter of 1983, 5.5 percentage points higher than at the end of the last recession. Partly as a result, real investment spending has fallen at an average annual rate of about 2 percent for the past three years, a decline that has contributed heavily to the slower pace of economic growth in the 1980s.

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Social Spending

Transfer payments have soared in recent years, reaching approximately $63 billion or 33 percent of the general government budget in 1982—10 percentage points more than in the United States and up at a real average annual rate of about 10 percent in the 1980-82 period (see table 3). About 85 percent of this spending is accounted for by the pension and health care systems, whose heavy deficits were an estimated $9.3 billion and $1.2 billion, respectively, last year.

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[1] The EPSD comprises the borrowing requirements of general government (central and local governments, social security funding, and subsidies to government-owned enterprises); autonomous agencies; municipal enterprises; and ENEL, the state-owned electricity monopoly. The EPSD, adopted in 1976 at the request of the IMF in order to capture the full impact of government borrowing on financial markets, is the government's yearly budget target.

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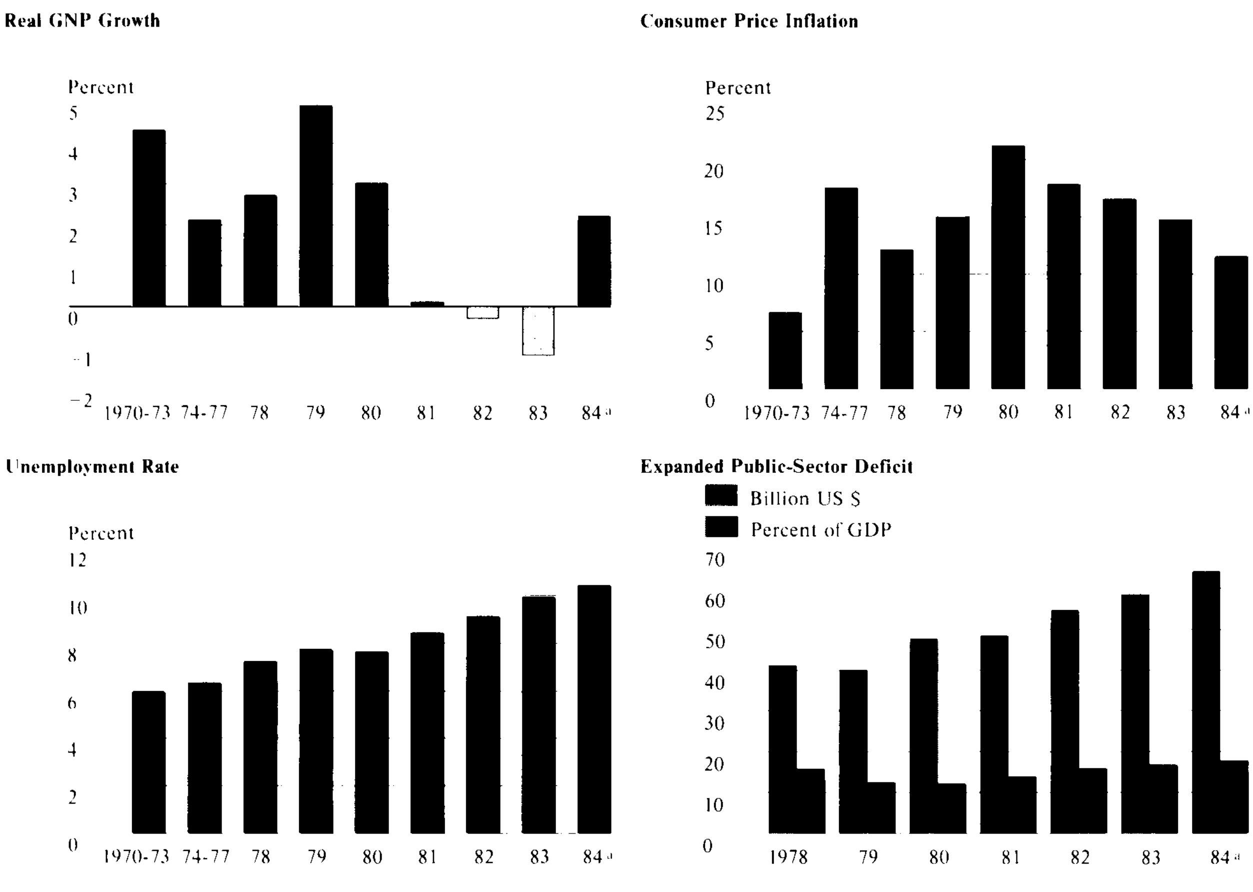
Italy: Economic Indicators, 1970-84



a Estimated.

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Although the aging of the population has contributed to the rise in expenditures, we believe Italian politicians bear a greater responsibility. In bidding for public support, they have made benefits increasingly generous and available to an ever broader swath of the population. The normal retirement age, for example, was uniformly set in the late 1970s at 60 for men and 55 for women—the lowest in the EC with the exception of France. In addition, disability pensions in Italy's depressed south are frequently used as unemployment compensation for groups not qualified for standard benefits.

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Table 1
Big Four and United States General Government Budgets as a Share of GDP

Percent

	1979		1980		1981		1982	
	Expenses	Revenue	Expenses	Revenue	Expenses	Revenue	Expenses	Revenue
Italy	45.6	36.2	46.4	38.0	51.1	39.2	54.4	42.1
West Germany	47.6	44.7	48.1	44.6	49.0	45.0	49.5	45.6
France	45.5	44.9	46.4	47.0	48.9	47.4	52.2	49.2
United Kingdom	42.0	38.9	44.0	40.2	45.1	42.7	44.2	42.2
United States	33.0	33.6	35.0	33.8	35.3	34.4	37.6	33.8

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The pension system, which has more liberal eligibility requirements than the US system, is a particular problem because Italy has only 1.4 workers for each pensioner—the lowest ratio among the major West European nations. For comparison, the US ratio is 3.5 to 1. Moreover, eligibility requirements for disability pensions are lax and about 40 percent of all pensioners nationwide receive disability pensions; in southern Italy disability pensioners outnumber retirement pensioners by almost 3 to 1. In addition, pensions have been indexed to allow for a real increase in benefits rather than simply compensating for inflation.

Government Payrolls and Local Financing

The traditionally bloated government payroll has also grown rapidly, reflecting in part the requirements of political patronage and the pressure to preserve jobs in the public sector. With the wages of civil servants recently growing faster than those in the private sector, civilian payroll expenditures reached $46 billion in 1982, equal to 24 percent of total general government expenditures.

The upward pressure on public expenditures has been compounded because regional and local governments have acquired considerable control over central government spending, notably in the areas of health and investment. Moreover, some transfers of funds to local governments are mandated by law, according to formulas that encourage high levels of current spending to ensure future funding.

The State Enterprises

The three huge and unprofitable holding firms in the state participation sector—IRI (heavy industry), ENI (energy), and EFIM (light industry)—have become an increasing drain on the budget. These conglomerates had combined losses of $3.6 billion last year and received capital transfers of nearly $13 billion in the 1980-83 period. Italian politicians have used these companies to pursue a variety of social and political goals, such as maintaining employment and promoting industry in Italy's underdeveloped south. As a result, state-sector firms tend to be inefficient, overstaffed, and often located far from markets and supply sources. Moreover, they typically are involved in the heavy industrial sectors most affected by the international recession and foreign competition.

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Frequently, jobs in the state enterprises are distributed on the basis of political patronage. In particular, senior managers are often selected for their political loyalties rather than their business acumen. The top posts in IRI, EFIM, and ENI, for example, are generally reserved for a Christian Democrat (DC), Social Democrat, and Socialist, respectively.

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Table 2 *Percent*
European Community and United States: General Government Deficits [a] as a Share of GDP

	1979	1980	1981	1982	1983 [b]
European Community	**−4.6**	**−4.8**	**−7.4**	**−7.7**	**−7.5**
West Germany	−2.9	−3.5	−4.0	−3.9	−3.6
France	−0.6	0.6	−1.5	−3.0	−3.1
United Kingdom	−3.1	−3.2	−2.4	−2.0	−2.0
Italy	−9.4	−8.4	−11.9	−12.4	−12.7
Belgium	−6.9	−9.3	−13.4	−12.8	−12.1
Denmark	−1.6	−3.2	−7.1	−9.5	−9.6
Greece	−4.6	0.4	−10.1	−9.2	−8.6
Ireland	−12.8	−15.4	−15.4	−14.7	−14.4
Luxembourg	0.1	−1.8	−0.8	−0.9	−1.0
Netherlands	−3.7	−4.1	−7.4	−8.4	−8.2
United States	**0.6**	**−1.2**	**−0.9**	**−3.8**	**−3.9**

[a] General government spending includes central and local governments and autonomous social security agencies. The expanded public-sector deficit, which showed the Italian budget deficit as a percentage of GDP at nearly 17 percent, includes general government, plus autonomous agencies, municipal enterprises, and ENEL, the state-owned electricity monopoly.
[b] Estimate.

Table 3 *Billion US $*
Selected General Government Spending, 1982

	Amount		Percent of Total Expenditures	
	US	Italy	US	Italy
Total Expenditures	1,168.5	189.0	100.0	100.0
Social Spending	266.6	63.0	22.8	33.3
Pensions	210.0	47.0	78.8 [a]	74.6 [a]
Health	49.7	6.4	18.6 [a]	10.2 [a]
Income Support	6.9	9.5	2.6 [a]	15.1 [a]
Interest	85.0	29.0	7.3	15.3
Civilian Salaries	285.5	45.5	24.4	24.1
Defense	178.6	7.7	15.3	4.1
Other [b]	352.8	43.8	30.2	23.2

[a] Percent of social spending.
[b] Includes subsidies, gross investment, and consumption expenditures.

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Revenue Shortfalls

Despite the positive effects of inflation and improved tax collection methods on tax revenues, Italy's budget deficits have been aggravated by the reluctance of political leaders to impose and enforce an equitable tax structure.[2] Studies show that certain categories of taxpayers, notably the self-employed and employees of smaller enterprises, pay few taxes relative to wage earners in larger firms—whose taxes are withheld from their paychecks. Evasion of the value-added tax (VAT) is believed to be particularly widespread. An official Italian study comparing 1976 tax returns with national income data suggested that only about 45 percent of income subject to VAT was being reported, against 80 percent of wage and salary income. A more recent private study based on 1980 data estimates that only about 70 percent of potential value-added taxes were collected. If this estimate was accurate and still holds true, uncollected value-added taxes were equivalent to about 20 percent of Rome's $58 billion budget deficit in 1983. Moreover, because value-added tax records are used in assessing income taxes, the understating of sales to avoid the value-added tax also reduces income tax assessments as well.

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The Political Process and Economic Problems

Italy's Byzantine political structure contributes enormously to the difficulty of formulating and carrying out policies that could deal with these problems. The electoral system is based on proportional representation, and 14 parties currently are represented in the Chamber of Deputies. With no single party able to come close to a working majority, short-lived multiparty coalition governments are the rule; the Craxi government is the 44th since World War II.[3]

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[2] Revenues have also been adversely affected by tax evasion in the large underground economy, which is frequently estimated at about 20 percent of GDP (although some estimates place it as high as 50 percent). Official GDP statistics are adjusted upward by 10 percent to take this into account.

[3] Italian governments are not quite as unstable as this statistic suggests. Italy's 44 governments have had only 17 different prime ministers, and several ministers have held their posts for at least four years. Moreover, three of the last four coalitions have been composed of the same five parties. Nonetheless, each change of government has usually involved the negotiation of a new government program, which has had an extremely disruptive effect on economic policy.

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The State Participation Enterprises

State firms, intended to combine the best features of private and public enterprise, started as salvage operations during the great depression of the 1930s, with the Fascists establishing the Instituto per la Ricostruzione Industriale (IRI) to consolidate state corporations in the vital areas of shipping, machinery, steel, and heavy chemicals. Holdings now also include firms in such sectors as electronics, telecommunications, foodstuffs, and automobiles. After World War II, the Ente Nazionale di Idrocarburi (ENI) was set up to manage the state's growing petroleum production and distribution sector but has been expanded to include holdings in the chemical, textile, and mining-metallurgic sectors. In 1982 ENI and IRI together accounted for almost all of the sales and employment of state enterprises. Ente di Partecipazione e Finanziamento Industria Manifatturiera (EFIM), set up in 1962, has holdings in the mining sector and the aluminum, food, machinery, and glass sectors.

The state holding companies account for almost 40 percent of sales and employment in Italy's 500 largest firms and over 20 percent of total industrial investment. The oil shocks of 1973/74 and 1979/80 hit the basic industries in IRI and ENI particularly hard. In the years after the first oil shock, instead of scaling back or closing affected firms, the state sector was enlarged to provide a home for industrial basket cases—largely at taxpayers' expense. As a result, after a modestly profitable year in 1973, operating losses representing less than 1 percent of sales were registered in 1974. Thereafter, operating losses have followed an upward trend, reaching over 6 percent of total sales of $55 billion in 1983. 25X1

In 1983 ENI lost about $900 million, in part because of its inability to fully pass on to consumers the effects of the 1979/80 oil price increases and the lira's depreciation against the dollar. In addition, losses in such crisis sectors as chemicals and textiles have also increased substantially, reflecting the international weakness of these sectors as well as ENI's increased acquisitions. Delays in the construction of nuclear plants, associated with strong opposition to the development of nuclear power, have added to the group's losses. Further, interest payments have more than tripled over the past three years, reflecting increases in both interest rates and indebtedness. 25X1

IRI, whose financial situation began to deteriorate during the early 1970s, is in even worse shape. Last year operating losses of $2.1 billion reached 9 percent of total sales. These losses have been concentrated in sectors that need substantial restructuring and are in a crisis situation worldwide. Nearly three-quarters of the losses are attributable to the steel sector, but losses in shipbuilding and maritime transport have also been substantial. 25X1

EFIM's losses quintupled during 1980-83, increasing from 3.5 percent of total sales to 20 percent. This reflected the depressed conditions in the energy-intensive aluminum sector brought about by the sharp fall in international prices and an increase in energy costs. 25X1

The short tenure of Italian governments makes medium- to long-term economic planning extremely difficult, and the reliance on multiparty coalitions requires Italy's leaders to perform a delicate balancing act in formulating economic policy. Christian Democratic prime ministers, for example, have had to put together programs that would satisfy not only the major factions of their own heterogeneous party, but also command the support of left-of-center parties—the Socialists and Social Democrats—while satisfying the fiscally conservative Republicans and the right-of-center Liberals. 25X1

Interparty squabbling has frustrated the development of any coherent approach to dealing with Italy's problems. Leftwing parties usually oppose measures to reduce social spending and argue that more efficient tax collection would more easily trim the budget deficit. The more conservative parties, although supporting a crackdown on tax cheating in principle, have

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more often than not protected special interests in practice. Passage of a controversial law requiring businesses to use cash registers, for example (thus forcing at least a temporary record of a transaction to be kept), was blocked for about four years as the DC bowed to the pressure from small businessmen, one of its major constituencies. [redacted]

As a result of these differences, policy has been geared to the lowest common denominator. Economic programs have emerged only after numerous compromises and trade-offs and have often lacked the necessary punch. For example, strong Socialist opposition kept a DC-led government from instituting harsh monetary and fiscal curbs to rein in inflation and improve the trade deficit in the mid-1970s. More recently, the effort of Prime Minister Fanfani's government in 1983 to trim a projected budget deficit by over $19 billion failed because of the absence of any political consensus: the Communists opposed social spending cuts, the Liberals opposed a surtax on the income of the self-employed, and the Socialists and the Social Democrats opposed extending a surtax to wage earners. [redacted]

Lack of Strong Leadership and Division of Authority

Cabinet differences are exacerbated by the weakness of the prime minister's office, a product of the distrust of strong leaders that resulted from the Mussolini era. The postwar Constitution made the prime minister more the chairman of a committee than a strong leader. Indeed, his official title is not prime minister but president of the council, and his position within the council tends to be that of a first among equals. As a result, ministries, and even divisions within ministries, can operate as independent units. In addition, it is difficult to move or shift ministers without altering the delicate balances within the coalition and triggering a government crisis (see table 4). [redacted]

The problems encountered by Republican Prime Minister Spadolini in 1981/82 illustrate the weakness of the prime-ministership. [redacted] 25X1

[redacted] Spadolini's attempt to replace his economics ministers ended abruptly when leaders of his coalition partners threatened to bring down his government. He was also unable to make other changes—such as merging the ministries of budget, finance, and industry into a superministry headed by an independent technician. As a result of having to divide ministry spoils among the parties, philosophical, personal, and political differences can impede policymaking and bring down governments. The government crisis in April 1983, for example, was precipitated in part by feuding between a Christian Democratic treasury minister and a Socialist finance minister. Christian Democrat Goria zeroed in on inadequate tax revenues—his rival's responsibility—as the source of the government's deficit. Finance Minister Forte blamed Goria's failure to control public spending. [redacted] 25X1

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Parliamentary Procedures

Economic programs worked out at the Cabinet level are often weakened by parliamentary procedures. Under Italy's bicameral system, identical bills have to be passed by both the Senate and Chamber of Deputies, so a draft may go back and forth between the two chambers many times. According to press reports, this year's budget and financial law, for example, was approved only after 210 votes. Another important and controversial procedure is the use of secret ballots on some issues, which has frequently led to defections from the governmental majority. The Socialists and Christian Democrats in particular have had difficulty maintaining party discipline in secret ballots. [redacted] 25X1

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In addition, the government's lack of control over the parliamentary agenda, excessive filibustering, and a growing volume of amendments to proposed legislation have compounded the delays—over 3,000 amendments were added by the opponents of a recent law limiting wage indexation in order to keep the bill from passing. Six of the last seven annual budgets were not approved until about four months past the 31 December deadline. In these cases Rome has had to resort to stopgap measures that allow provisional budget appropriations on a prorated basis. [redacted] 25X1

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Table 4
Party Affiliations of Selected Economic Ministers

	Ministry	Party
Pierluigi Romita	Budget and Economic Planning	Social Democrat
Bruno Visentini	Finance	Republican
Giovanni Goria	Treasury	Christian Democrat
Nicola Capria	Foreign Trade	Socialist
Celio Darida	Government Holdings	Christian Democrat
Renato Altissimo	Industry, Commerce, and Crafts	Liberal
Gianni De Michelis	Labor and Social Security	Socialist

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On frequent occasions, Italian governments have gotten around the legislative maze only by resorting to decree (emergency) laws. The decrees lapse if not converted into law by Parliament within 60 days, but, in practice, some have been renewed several times in modified form without parliamentary approval. 25X1

Resort to decrees has been so frequent that legislators have come to view the measures as normal legislation subject to the same parliamentary pitfalls. Moreover, the government has to take additional time to modify a decree each time it is rejected. For example, several key pieces of Prime Minister Craxi's economic legislation that were issued as decrees in early fall of 1983 have been modified several times and have yet to pass. In addition, debate on important decrees can impede progress on other bills as the government tries to beat the 60-day deadline. Debate last June on a measure limiting wage indexation met with heavy opposition from the Communist Party and the Communist-dominated CGIL labor union and restricted discussion on other issues. Although the measure eventually passed, compromises with the opposition resulted in a much-weakened measure. 25X1

The Travails of the Craxi Government

The problems the Italian political system creates in the area of economic policy making are clear in the difficulties that Craxi has had in coming to grips with the budget deficit. All of the current coalition parties agree—at least in principle—that a "rigorous" approach is needed for the economy, but their campaign positions in the 1983 national election make clear that important differences over priorities separate them:

- The Christian Democrats favored holding down the growth in government spending, modifying the wage indexation system that brings wages into line with the cost of living on a quarterly basis, establishing an incomes policy to hold wage increases in line with inflation targets, and restricting money growth.

- The Socialists rejected austerity in principle, holding that the structural deficit will correct itself over time with economic growth resulting from government spending and tax incentives. For the PSI, "rigor" meant a crackdown on tax evasion.

- The Republicans advocated free enterprise and fiscal conservatism, called for gradually eliminating indexation throughout the economy, progressively slowing the growth of the money supply, keeping wage increases within government inflation targets, and cutting the budget deficit as a percentage of GDP through reductions in current spending and higher taxes.

- Like the Republicans, the much smaller and more narrowly based Liberal Party represents the interests of industrialists and the entrepreneurial middle class. The Liberals wanted inflation controlled through cutting the public-sector deficit and containing labor costs.

- The Social Democrats, on the other hand, did not place much emphasis on fighting inflation. The party called for higher taxes, maintaining social benefits (especially pensions), and stimulating investment through increases in productivity.

The opposition Communists, meanwhile, enjoy substantial behind-the-scenes influence by virtue of their status as Italy's second-largest party, their heavy representation on key parliamentary committees, and their influence on Italian labor.[4] Moreover, the PCI has often obstructed key legislation, such as a recent bill limiting wage indexation, for its own political purposes. In last June's national elections, the Communists called for balancing the budget over time through a crackdown on tax evasion, a complete revision of the tax system, and higher tax rates for private companies and higher income groups. However, they also called for more government spending on infrastructure projects, the creation of new jobs, and expensive social programs such as more generous unemployment compensation.

As a result of these many pressures, Craxi's economic program has something for everyone:

- The anti-inflation goals of the DC.

- Calls for tougher tax enforcement to please the Socialists and soften Communist opposition.

- Pledges to reform the welfare system by changing the benefit structure and promises to hold down government spending—objectives shared by the Liberals, Social Democrats, Republicans, and Christian Democrats.

[4] The 1983 parliamentary elections reconfirmed the PCI's position as the second-largest party. In the June 1984 European parliamentary elections, however, the PCI outpolled the Christian Democrats by 0.3 percentage point.

In addition to compromises in the program, Craxi was forced to divide the key economic ministries among the coalition parties. The DC was given the treasury ministry; the Republicans, the finance ministry; and the Social Democrats, the budget ministry. 25X1

The government's efforts to hold the 1983 budget deficit to $53 billion were hindered by the opposition of some DC members who blamed their election losses on the party's advocacy of economic rigor. As a result, the Craxi government quietly abandoned its 1983 budget target, and the deficit exceeded $58 billion. At the same time, its efforts to pass by decree a measure to collect $5.4 billion in unpaid fees for illegal housing construction were frustrated. In the first legislative test of the government decree, 27 Christian Democrats defected in a secret ballot, and the Chamber of Deputies defeated the so-called amnesty bill—Rome is still trying to pass a weakened revised version.

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The 1984 Budget

Faced with official projections that the 1984 deficit could soar to as much as $84 billion—$30 billion above the target Craxi established as a goal on taking office—the Cabinet approved a 1984 "austerity" budget in December of last year. Despite its label, the budget aims only at slowing the growth in spending from about 25 percent in 1983 to 15 percent in 1984. Moreover, its measures to increase tax receipts are mostly one-time actions that will have little impact on future deficits. Indeed, about 70 percent of the projected savings are based on estimates of lower debt service costs (in the expectation interest rates will fall substantially) and increased tax receipts (in part because of a hoped-for buoyant recovery); we believe both are overly optimistic. 25X1

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The final version of the 1984 budget is designed to lower the deficit to 15.9 percent of GDP, $56.9 billion at current exchange rates, and even this figure assumes $6.6 billion in revenue from the construction

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amnesty law and from a bill to allow the redeposit of excess local funds into the Treasury. Cuts in the rate of growth of social security and health spending will be less than anticipated, and pension cuts—opposed by some members of the DC and the Liberal Party—also will fall short of the government's initial target. In addition, the government's decision to "buy" Communist support will cost $900 million in additional appropriations for local governments where the opposition PCI has an important role. Moreover, Rome succeeded only in partially delinking pensions and prices for pensions above a certain minimum level.[5]

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In our view, the government's 1984 projections are almost certainly too optimistic; we expect the deficit to jump to $64 billion, 17.6 percent of GDP:

- Rome will undoubtedly fail to gain forecasted additional revenues with its amnesty bill, which threatens politicians by highlighting the fact that they looked the other way when illegal construction occurred. It has run into strong parliamentary opposition, and opponents at one point called for individual votes on all 54 articles of the bill.

- The attempt to limit wage indexation, which the government hoped would result in total direct and indirect budgetary savings of $1.4 billion—some $700 million in public payroll savings alone—ran into strong Communist opposition. Communist Party maneuvering in Parliament prevented approval of the decree, and the government passed a weaker proposal that officials estimate will result in total budget savings of only about $700 million. The PCI is trying to call a national referendum to reverse the law.

- Even if the PCI fails, the budget gains resulting from the watered-down proposal to limit wage indexation will be partially offset by Rome's concessions to gain labor's acceptance of the curbs, including establishing trainee positions in the public and private sector (especially for youth in the south), reducing the employers' share of employee health benefits ($4.8 billion), and postponing price increases for pharmaceutical products. 25X1

Longer Term Outlook

The longer term economic outlook is critically dependent on the will and ability of Italian politicians to overcome the obstacles to policymaking created by their labyrinthine political system. Italian policymakers, however, are reluctant to face the short-term consequences of deficit-cutting measures. US Embassy sources report that they still view the deficit as manageable and feel little pressure for major retrenchment. In the absence of strong outside pressure such as a balance-of-payments crisis, we believe Rome will continue to move at a relatively slow pace on the reforms needed to resolve the budget issue. 25X1

Economic Reforms

Effective action on tax evasion measures and pension reform proposals seems unlikely any time soon. Republican Finance Minister Visentini, who for a year resisted laws to reduce tax evasion by the self-employed and small businesses that represent an important segment of his party's electorate, finally caved in and issued a set of proposals aimed at broadening the tax base and reducing evasion. Nevertheless, strong pressure from affected groups could weaken Republican resolve to pass the measures. Visentini's position is likely to be crucial, because proposals in this area fall into his ministerial domain. Meanwhile, pension reform proposals likely will be held up in parliamentary debate despite coalition agreement on a compromise proposal. Both the PCI and the CGIL are opposed to certain measures, especially increases in the retirement age; strong parliamentary opposition kept the Fanfani government from passing similar proposals. 25X1

[5] Old age pensions were previously indexed by a complex mechanism both to minimum wages and prices. For minimum pensions, percentage increases were equal to increases in an index of minimum wages in manufacturing. For pensions above the minimum, indexation consisted of a fixed number of lire being granted to all pensioners per each percentage point increase in a price index. As a result, smaller pensions received proportionately larger cost-of-living adjustment. The link to wages consisted of applying the same percentage increase to all pensioners based on the difference between minimum wage growth and a price index. Rome apparently has modified only the link between pensions and prices. Now, old age pensions are indexed directly to the percentage rise with a 75-percent ceiling on pensions greater than twice the minimum pension. The move from a flat-rate indexation system to a proportional system reduces the adjustment for the lowest pensions but increases it for the highest pensions, even allowing for the 75-percent ceiling.

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The picture is not totally bleak, however. The government is trying to cut outlays to state firms and has proposed labor reform legislation that could lead to lower labor costs for state companies. In addition, IRI (Italy's heavy industry holding company) and ENI (Italy's energy agency) are preparing to infuse much-needed capital by selling partial ownership in some of their holdings. [redacted]

Political Reforms

On the political side, the Craxi government has engineered some administrative reforms that could make the budgetary process function more smoothly and ease the way for retrenchment, should Italy's politicians ever find the will to pursue it.[6] The changes include:

- Raising the number of deputies required to call a secret vote in Parliament or introduce amendments to legislation.
- Limiting the time for debate on the budget bill.
- Instituting a special 45-day parliamentary session for dealing with budget matters.
- Limiting the time budget legislation can remain in committee. [redacted]

In and of themselves, these changes clearly are not sufficient to reduce substantially the problems inherent in multiparty government or the muddle-through mentality of Italian policymakers. Nonetheless, they appear to have had an important psychological impact on the Chamber. More importantly, they have made it harder for the minor parties to hold up budget legislation. According to press reports, Rome is considering further measures, including procedures for the approval of financial laws, additional limits on discussion time, and special procedures for "preferential passage" of key legislation. [redacted]

Economic and Political Consequences

We do not expect Rome, unless forced by public pressure or balance-of-payments problems, to undertake the budgetary retrenchment necessary to improve its long-term outlook. Recent policy debates point to the government doing nothing more than muddling through by means of ad hoc policy measures that would allow tax evaders to pay back taxes without penalties and minor pension reforms. The Craxi coalition's policy review document last July, for example, was couched in vague language and glossed over the deficit problem. Indeed, coalition members, particularly Socialist Labor Minister De Michelis, already have attacked DC Treasury Minister Goria's proposals designed to hit a deficit target of 8 percent of GDP by 1988. Moreover, according to US Embassy sources, Italy's somewhat improved economic picture—a tenuous moderate economic recovery and somewhat lower inflation—is easing pressure on officials to act. [redacted]

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The Christian Democrats' waning strength at the polls will continue to weaken their influence over their coalition partners.[7] This condition is almost certain to yield coalitions that are even more unstable and more reliant on ineffective, common denominator policies. As a result, we believe Rome's fiscal picture will be characterized by, at best, a slight moderation in spending, little change in taxes as a share of GDP, and a moderate improvement in the deficit's share of GDP. This will have several negative consequences for the Italian economy:

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- There will be a sustained high rate of inflation due, in part, to excessive money growth generated by the high deficit. Inflation will probably stay in the double-digit range through the end of the 1980s, still well above rates for other industrial nations.
- Real interest rates will remain high and limit investment spending.

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[redacted]

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[redacted]

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- With investment constrained, exports will have to play a more important role than before in sustaining growth. Slower expansion in key LDC and EC markets, however, will combine with competitiveness problems to limit export growth to about 4 percent in real terms, below the overall expansion in world trade. As a result, we expect real GDP growth to be kept to an average annual rate of about 2.5 percent through the end of the 1980s, as compared with about 3.8 percent in the late 1970s.

- Slower growth, in turn, will contribute to a sustained high rate of unemployment. [redacted]

Should Italy's problems worsen and require a strong dose of austerity, and particularly if Italy should develop balance-of-payments problems, public pressure for a more effective government would grow and could result in a search for alternative governing formulas. These could include a one- or two-party Socialist/Christian Democratic government with outside support from the minority parties. Less likely, but still possible, would be a further opening to the left, bringing the Communist Party, either directly or indirectly, into the government. [redacted] 25X1

Inevitably, political commentators have suggested that bringing the PCI directly into the government would moderate the party's calls for greater social spending and lead to more effective government by making the Communists more responsible for policy. In 1976-79, the formation of a government of national solidarity—where the PCI remained outside of the government but agreed to abstain on key economic measures—allowed significant austerity legislation to be passed. [redacted] 25X1

An enhanced role for the Communists could have direct consequence for US interests, including:

- Weakened Italian support for NATO programs and projects.
- New barriers to Italian military force modernization.
- Questioning by Rome of US access to Italian ground facilities or airspace in the event of future crises in the Mediterranean.
- Dampening of Italy's new activism in foreign policy, which is reflected in its participation in peacekeeping activities such as in Lebanon, the Sinai, and the Suez. [redacted] 25X1

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